

State Dept. review completed

C O N F I D E N T I A L

MSGNO 23 (STXX) Z1A *17/02/82* *14:49*
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CONFIDENTIAL

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FM AMEMBASSY LONDON
TO RUEHC/SECSTATE WASHDC IMMEDIATE 6823
INFO RUEHKK/EC COLLECTIVE
RUEHKO/AMEMBASSY TOKYO 9949
RUEHMO/AMEMBASSY MOSCOW 6941
RUDKRP/AMEMBASSY PRAGUE 1443

BT

EZ1:

C O N F I D E N T I A L LONDON 03580 COMBINED SECTION

EZ2:

USEC ALSO FOR EMBASSY

E.O.12065: RDS-1 2/17/02 (STREATOR, E.J.) OR-M

TAGS: ETRD, EEW, UK, UR

SUBJCT: SOVIET GAS PIPELINE: VIEWS OF UK COMPANY

1. CONFIDENTIAL - ENTIRE TEXT.

2. SUMMARY:

JOHN BROWN LTD. OFFICIALS, WHO HOLD A CONTRACT FOR
PRODUCING 21 GE TURBINES FOR THE SOVIET GAS PIPELINE,
ALLEGED THAT:-- THE COMPANY CANNOT SURVIVE AN EXPECTED \$100 MILLION
LOSS FROM ABROGATING THE CONTRACT, NOR DO THEY FORESEE
THE BRITISH GOVERNMENT ALLOWING IT;-- THE SOVIETS ARE INCREASING PRESSURE ON THE EUROPEAN
COMPANIES TO PROVIDE NEW SUPPLY ASSURANCES OR DEVELOP A
"EUROPEAN SOLUTION;"-- JOHN BROWN HAS BEEN RESTRAINED BY HMG, BUT ALSTHOM
ATLANTIQUE IS MOVING WITH FRENCH GOVERNMENT SUPPORT TO
INCREASE ROTOR PRODUCTION;-- OTHER SOVIET OPTIONS INCLUDE SUBSTITUTING EXISTING
GAS TURBINES, DEVELOPING INDIGENOUS PRODUCTION CAPACITY,
AND COMPLETING THE PIPELINE WITH GE ENGINES FOR LATER
ADDITION OF ROTORS;-- U.S. SANCTIONS ALREADY HAVE DELAYED THE PIPELINE'S
FIRST PHASE BY A YEAR, AND CONTINUED RESTRICTIONS MAY

C O N F I D E N T I A L

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25X1

C O N F I D E N T I A L

MSGNO 23 (STXX) Z1A *17/02/82* *14:49*
DELAY IT ANOTHER. BUT SOVIET SUPPLY ALTERNATIVES WILL
PERMIT CONTRACTED DELIVERIES AND FOREIGN EXCHANGE
EARNINGS:

-- EUROPEAN DETERMINATION TO COMPLETE THE PIPELINE AND
U.S. DESIRE TO LEVERAGE SOVIET BEHAVIOR IS BEST ACCOMMO-
DATED BY ALLOWING EXISTING CONTRACTS AND RESTRICTING
FUTURE SUPPLIES;

-- LARGE SCALE GAS TURBINE PRODUCTION CAPABILITY WILL NOW
SHIFT TO EUROPE AND JAPAN, SERIOUSLY UNDERCUTTING A RANGE
OF FUTURE U.S. EXPORTS AND CONTROLS. GE EXPECTS SERIOUS
DIFFICULTY IN RENEWING UPCOMING PRODUCTION AGREEMENTS.
END SUMMARY.

3. EMBOFF MET FEBRUARY 12 WITH R. MCCABE, DIRECTOR OF
JOHN BROWN ENGINEERING LTD., AND J. McDOWELL OF THEIR
SUBSIDIARY JOHN BROWN ENGINEERING GAS TURBINES LTD. THEY
HAD REQUESTED THE MEETING IN LONDON TO SEE DIANE SMITH
OF THE SENATE FOREIGN RELATIONS COMMITTEE STAFF AT THE
SUGGESTION OF THE BRITISH EMBASSY IN WASHINGTON. DUE TO
SCHEDULING PROBLEMS, MS. SMITH WAS PRESENT FOR ONLY ABOUT
HALF THE MEETING. WE UNDERSTAND MCCABE MET WITH DAS
ALLEN WENDT AT STATE AND DAS BO DENYSYK AT COMMERCE VERY
RECENTLY, SO SOME OF THE FOLLOWING VIEWS MAY BE AVAILABLE
ALREADY TO WASHINGTON. WE HAVE NOT ATTEMPTED TO VERIFY
ASPECTS OF THE CONVERSATION, PARTICULARLY THE ALLEGATIONS
OF FRENCH GOVERNMENT ACTIONS TOWARDS ALSTHOM, AEG PLANS,
OR SOVIET/CZECH TURBTNE PRODUCTION ABILITY.

POSITION OF JOHN BROWN:

4. MCCABE SAID THAT JOHN BROWN ENGINEERING LTD. WAS
CONTINUING WORK ON THE SIX TURBINES FOR WHICH THEY HAD GE
ROTORS. THE ROTORS HAVE BEEN IN THE UK SINCE 1978. THE
COMPANY IS INCURRING OPERATING COSTS OF APPROXIMATELY \$20
MILLION EACH MONTH. IF THEY FAIL TO MOVE FORWARD
ON THE PIPELINE CONTRACT, THEIR LOSSES WOULD BE APPROXI-
MATELY 100 MILLION DOLLARS. BOTH MEN STATED CATEGORICALLY
THAT THE FIRM WOULD NOT SURVIVE A TERMINATION OF THE
CONTRACT DUE BOTH TO THE LOSS OF BUSINESS, AND THE LOSS OF
THEIR PERFORMANCE BOND AND BREACH OF CONTRACT LIABILITY
TO THE SOVIETS. MOST OF THE 2,000 PEOPLE WHO WOULD BE
LAID OFF WOULD NOT FIND ALTERNATIVE EMPLOYMENT IN THE
ALREADY VERY DEPRESSED GLASGOW AREA. THEY STRESSED THAT
THE POLITICAL REPERCUSSIONS WOULD BE SEVERE AND THEY HAD
DIFFICULTY CONCEIVING THAT THE GOVERNMENT WOULD SIT BY AND
LET THE COMPANY GO UNDER DUE TO U.S. ACTIONS. UP TO NOW,
HMG QUIETLY HAS PUT PRESSURE ON JOHN BROWN TO TAKE A
CONCILIATORY ATTITUDE AND NOT TRY TO EVADE THE US EXPORT
RESTRICTIONS. COMPANY OFFICIALS SEEM TO BELIEVE, HOWEVER,
THAT AT THE END OF THE DAY, THE BRITISH GOVERNMENT COULD
NOT SUPPORT THE IDEA THAT THE US HAS JURISDICTION OVER
ROTORS NOW IN THE UK.

5. MCCABE WAS VERY CONCERNED OVER INCREASING SOVIET
PRESSURE ON THE FIRMS. THE ENTIRE ISSUE FOR THE COMPANY
MAY BE FORCED TO A HEAD WITHIN THE NEXT TWO WEEKS. THE
SOVIETS HAVE GIVEN JOHN BROWN THAT LONG TO COME UP WITH A
SIGNED COMMITMENT PROMISING TIMELY DELIVERY OF ALL FUTURE
TURBINES OR FACE LOSS OF THE COMPANY'S \$10 MILLION PERFOR-
MANCE BOND, WHICH IS 5 PERCENT OF THEIR \$208 MILLION CON-
TRACT. ALTHOUGH THE FIRST BATCH OF 6 TURBINES FROM JOHN
BROWN IS NOT DUE UNTIL THIS JUN. THE PERFORMANCE BOND OF

C O N F I D E N T I A L

MSGNO 23 (STXX) Z1A *17/02/82* *14:49*

MOST EUROPEAN CONTRACTORS CAN BE CALLED WHEN THERE IS REASONABLE EXPECTATION THAT PRODUCTION SCHEDULES WILL NOT BE MET. JOHN BROWN NOW WISHES TO AVOID COMMITTING ITSELF IN WRITING TO THE ADDITIONAL 15 TURBINES DUE TO BE DELIVERED BY JANUARY OF 1983. MCCABE CLAIMS THE GE PLANT AT SCHENECTADY, NEW YORK, HAS SLOWED PURCHASE OF RAW MATERIALS AND CUT BACK PRODUCTION, AND IS THEREFORE UNLIKELY TO PRODUCE SUFFICIENT ROTORS TO MEET THEIR SUPPLY AGREEMENT WITH JOHN BROWN BY THIS JUNE. JOHN BROWN NEEDS THE ADDITIONAL ROTOR KITS THIS JUNE TO BEGIN WORK ON THE TURBINES FOR COMPLETED DELIVERY BY JANUARY 1983. HE NOTED THAT, AS WITH THE AEG CONTRACT, JOHN BROWN TAKES DELIVERY OF THE ROTORS IN THE US AND IS RESPONSIBLE ITSELF FOR THE EXPORT LICENSES. YET, HE DID NOT FORESEE GENERAL ELECTRIC AND JOHN BROWN ENTERING COURT OVER THIS ISSUE AS THEY HAVE A LONG AND CLOSE RELATIONSHIP IN WHICH COMMERCIAL DIFFERENCES ARE ALWAYS SETTLED. HOWEVER, THIS RESTRAINT MAY NOT BE THE CASE WITH AEG WHICH IS IN DESPERATE FINANCIAL STRAITS. NJOVO PIGNONE, ON THE OTHER HAND, WAS A LARGE COMPANY AND LIKE JOHN BROWN COULD FALL BACK ON THE FINANCIAL RESOURCES OF A PARENT IF THE COMPANY HAD TO CEASE OPERATIONS.

THE "EUROPEAN SOLUTION"

6. MCCABE AND McDOWELL HAD JUST COME FROM MEETINGS IN PARIS WITH MACHINODIMPDRTX AND THE OTHER MAIN EUROPEAN CONTRACTORS. JOHN BROWN IS WELL CONNECTED IN THIS BUSINESS AND HAS BEEN SUPPLYING TURBINES TO THE SOVIETS FOR OVER 10 YEARS UNDER PREVIOUS CONTRACTS. MCCABE SAID THE SOVIETS WERE PRESSING THE EUROPEAN COMPANIES TO COME UP WITH AN ALTERNATIVE NON-U.S. PLAN WHICH HE SAID WAS SLOWLY TAKING SHAPE. WHILE JOHN BROWN HAS BEEN RESTRAINED BY HMG FROM ACTIVE PARTICIPATION IN SUCH A SOLUTION, THE GERMAN AND FRENCH COMPANIES WERE MOVING AHEAD. HE NOTED THAT THE SOVIETS WERE BARGAINING FOR THIS "EUROPEAN SOLUTION" BY AGREEING NOT TO PURSUE LEGAL MEASURES AGAINST THE FIRMS, SEVERAL OF WHOM ARE IN A POOR NEGOTIATING POSITION DUE TO SERIOUS FINANCIAL DIFFICULTIES. BOTH MEN NOTED THAT AEG, LIKE THEMSELVES, COULD NOT SURVIVE THE LOSS OF THE TURBINE CONTRACT.

7. McDOWELL, NOTING THE FRENCH HAVE THE TECHNOLOGY THROUGH ALSTHOM ATLANTIQUE TO PRODUCE THE ROTORS, SAID THE FIRM IS QUIETLY SEEKING INVESTMENTS TO FINANCE A MAJOR INCREASE IN ROTOR PRODUCTION BEYOND THE 40 SPARE ROTOR KITS WHICH THE SOVIETS CONTRACTED FOR TWO YEARS FROM NOW. HE SAID ALSTHOM TOLD JOHN BROWN THEY MUST PLACE ORDERS NOW IF THEY WANTED TO BE ASSURED OF A NON-AMERICAN SUPPLY FOR THE FUTURE. HOWEVER JOHN BROWN, WHICH RECENTLY SIGNED A NEW 10 YEAR AGREEMENT WITH GE, TURNED THEM DOWN. AEG IS STUDYING THE POSSIBILITY OF PRODUCING THEIR OWN ROTORS. McDOWELL SAID AEG ONCE WERE LEADERS IN THE TURBINE BUSINESS AND HE BELIEVES THEY CAN AGAIN DEVELOP THE CAPACITY WITH SOME QUALITY COMPROMISES AND DELAYS. MCCABE SAID HE LEARNED ON FEBRUARY 11 THAT ALSTHOM QUIETLY WAS GIVEN THE NECESSARY ASSURANCES BY THE FRENCH GOVERNMENT DURING THE FRENCH-SOVIET GAS CONTRACT NEGOTIATIONS ON JANUARY 8, TO GEAR UP FOR LARGER SCALE ROTOR PRODUCTION. McDOWELL WAS OPTIMISTIC ON THE ENGINEERING FEASIBILITY OF PRODUCING USABLE (IF NOT FULLY COMPARABLE) ROTOR PARTS IN EUROPE.

C O N F I D E N T I A L

MSGNO 23 (STXX) ZIA *17/02/82* *14:49*
OTHER SOVIET OPTIONS.

8. MCCABE SAID THE SOVIETS COULD USE OTHER EXISTING PIPELINE CAPACITY TO MEET THE FIRST STAGE OF THEIR GAS CONTRACT OBLIGATIONS. (ESSO EUROPE, A SHAREHOLDER IN RUHRGAS, SEPARATELY CONFIRMED THAT POINT.) MEANWHILE SOVIETS PROBABLY WILL CONTINUE CONSTRUCTING THE NEW PIPELINE AND MAY USE, FOR THE INTERIM, SMALLER CAPACITY TURBINES PREVIOUSLY EXPORTED TO THE SOVIET UNION. McDOWELL SAID ON ALREADY CONSTRUCTED PIPELINES, WHERE THE SOVIETS NEEDED ABOUT 100 TURBINES, THEY CHARACTERISTICALLY BOUGHT ABOUT 150 WHICH THEY COULD NOW TRANSFER AND CANNIBALIZE TO USE ON THE NEW PIPELINE UNTIL LARGER TURBINES BECOME AVAILABLE. THIS WOULD ALLOW THE YAMAL PIPELINE TO OPERATE AT ABOUT 30 PERCENT CAPACITY.

9. McDOWELL NOTED THAT THE SOVIETS ARE ALSO INVESTIGATING THE POSSIBILITY OF A PRODUCTION ARRANGEMENT WITH THE CZECHS TO PRODUCE LARGER GAS TURBINES. HE ALSO SAID HE RECENTLY LEARNED WITH GREAT SURPRISE FROM A FORMER CLOSE SOVIET FRIEND WHO WORKS AS AN INSPECTOR ON PIPELINE CONSTRUCTION THAT THE RUSSIANS ALLEGEDLY HAVE PUT TOGETHER A LARGE AERO-DERIVATIVE GAS TURBINE PROTOTYPE FROM PARTS AVAILABLE WITHIN THE SOVIET UNION AND ARE EXAMINING THE POSSIBILITY OF PRODUCTION.

10. A THIRD MIXED OPTION WHICH THE SOVIETS ARE SERIOUSLY CONSIDERING IS TO MAINTAIN AS CLOSE AS POSSIBLE THEIR PRESENT PIPELINE CONSTRUCTION SCHEDULE AND PLACE SMALLER CAPACITY TURBINES ALONGSIDE THE UNCOMPLETED GE ENGINES. AS THE ROTOR KITS BECOME AVAILABLE, THEY COULD BE EASILY INSTALLED IN THE GE TURBINES ON SITE WITH LITTLE ENGINEERING DIFFICULTY AND THE COMPLETION OF THE PIPELINE RAISED IN STAGES OVER TIME.

LONG TERM IMPACT OF U.S. SANCTIONS:

11. MCCABE AND McDOWELL NOTED THAT U.S. RESTRICTIONS COULD CAUSE UP TO A TWO YEAR DELAY IN COMPLETING CONSTRUCTION OF THE FIRST PHASE OF THE PIPELINE, BUT THE SOVIETS NEVERTHELESS WILL BE ABLE TO MEET GAS DELIVERY CONTRACTS. THEY SAID THE COST OF THIS DELAY TO THE U.S. WAS THE CERTAINTY THAT LARGE SCALE PRODUCTION CAPACITY FOR AERO-DERIVATIVE TURBINES WOULD NOW SHIFT TO EUROPE AND JAPAN. JOHN BROWN, WITH A NEW LONG TERM GE PRODUCTION AGREEMENT, REGRETS THIS SINCE IT BELIEVES GE'S TECHNOLOGICAL AND COST LEADERSHIP IN THE WORLD MARKET HAS SUFFERED A PERMANENT SETBACK. THEY PREDICT COMPETITORS WILL USE THE SPECTER OF FUTURE U.S. EXPORT CONTROLS TO GAIN CONTRACTS BY ARGUING THAT U.S. PRODUCTS HAVE AN ADDITIONAL UNCERTAINTY COST.

12. BOTH MEN ADDED THAT CONTINUED U.S. STRICTURES WOULD NOT DELAY SOVIET FOREIGN EXCHANGE EARNINGS OVER THE NEAR TERM BECAUSE OF ALTERNATE GAS DELIVERY OPTIONS. EVEN IF U.S. SANCTIONS ARE LIFTED ON U.S. PARTS IN EUROPE NOW UNDER EXISTING CONTRACTS, THEY ARGUE THAT THE OVERALL SOVIET PIPELINE TIMETABLE HAS ALREADY BEEN DELAYED BY AT LEAST ONE YEAR DUE TO THE NARROW WEATHER WINDOWS IN THE USSR FOR TRANSPORTATION AND CONSTRUCTION. THEY REASONED THAT OUR BEST COURSE WOULD OBTAIN BY ALLOWING EXISTING CONTRACTS TO GO FORWARD, AND THEN QUIETLY LEVERAGING FUTURE SUPPLIES AND CONTRACTS TO SPECIFIC CHANGES IN

C O N F I D E N T I A L

MSGNO 23 (STXX) Z1A *17/02/82* *14:49*

SOVIET BEHAVIOR. THEY SAID THE NATURE OF THE U.S. APPROACH TO DATE HAS ALIENATED BOTH EUROPEAN COMPANIES AND THEIR GOVERNMENTS, SEVERALLY STRAINED ECONOMIC AND POLITICAL RELATIONSHIPS, AND DIVERTED THE INTENDED FOCUS FROM SOVIET ACTIONS IN POLAND. HE SAID THE EUROPEANS WERE DETERMINED TO GO FORWARD WITH SOME PURCHASES OF SOVIET GAS BECAUSE OF CONCERN ABOUT ALGERIA'S RELIABILITY AS A SUPPLIER.

13. IN A SEPARATE CHANCE CONVERSATION IN EARLY FEBRUARY BETWEEN EMBASSY AND ONE OF GE EUROPE'S LEGAL REPRESENTATIVES (PROTECT), LATTER SAID THAT MANY OF THE GE PRODUCTION AGREEMENTS WITH EUROPEAN FIRMS ARE UP FOR RENEWAL IN 1982. HE ANTICIPATED VERY DIFFICULT NEGOTIATIONS ON SUPPLY ASSURANCES FOR THOSE COMPANIES WILLING TO RENEW. OTHERS ARE LOOKING AT SUPPLY AGREEMENTS WITH HITACHI, ANOTHER MAJOR GE COMPETITOR, BECAUSE OF QUESTIONS FROM THIRD MARKETS ABOUT THE SECURITY OF U.S. SUPPLIERS. LOUIS

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